



U.S. ECONOMIC & INTEREST RATE OUTLOOK

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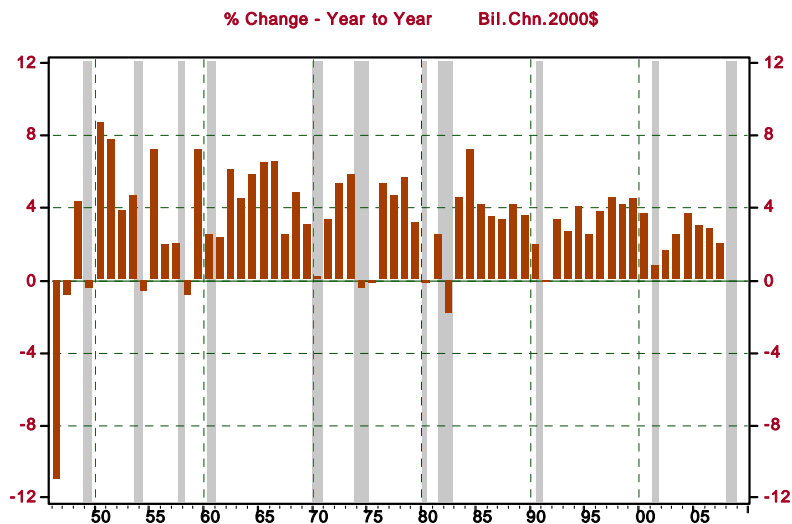
The Worst Recession since the Great Depression? Perhaps, But...

December 15, 2008

The NBER finally has told us what most of us already knew – the U.S. economy has once again entered a recession. According to the NBER, the recent business expansion peaked in December 2007. Thus, as of December 2008, the economy has been in a recession for 12 months vs. an average post-war recession duration of 10 months. The longest post-war recessions, 1973-1975 and 1981-1982, lasted 16 months. We do not expect the next expansion to commence until the fourth quarter of 2009. Therefore, we estimate that the current recession will set a post-war record for being the longest. During the so-called Great Depression of the 1930s, there were two periods of business contraction – August 1929 through March 1933 (43 months) and May 1937 through June 1938 (13 months).

In terms of recession depth, we are forecasting that real GDP on an annual average basis will contract by 2.1% in 2009. In the December 2008 Blue Chip survey of economic forecasts, there was one forecaster more pessimistic than us for 2009, expecting a 2.3% contraction in real GDP. After data releases for the week ended December 12, this forecaster is now expecting real GDP to contract by 2.9% on an annual average basis in 2009. (We lowered our 2009 forecast by 0.1 percentage points from what was published in the latest Blue Chip survey.) From 1946 through 2007, the largest annual average decline in real GDP occurred in 1982 at 1.9% (see Chart 1). So, if our forecast or our even more pessimistic competitor's forecast is on the mark, the current recession, in terms of a one-year decline in real GDP, would be the most severe *recession* in the *post-war* era. (Chart 1 shows the decline in annual average real GDP in 1946 was considerably larger, at 11.0%. However, this decline apparently was associated with the transition to a peace-time economy and was *not* designated as a recessionary period.)

Chart 1
Real Gross Domestic Product

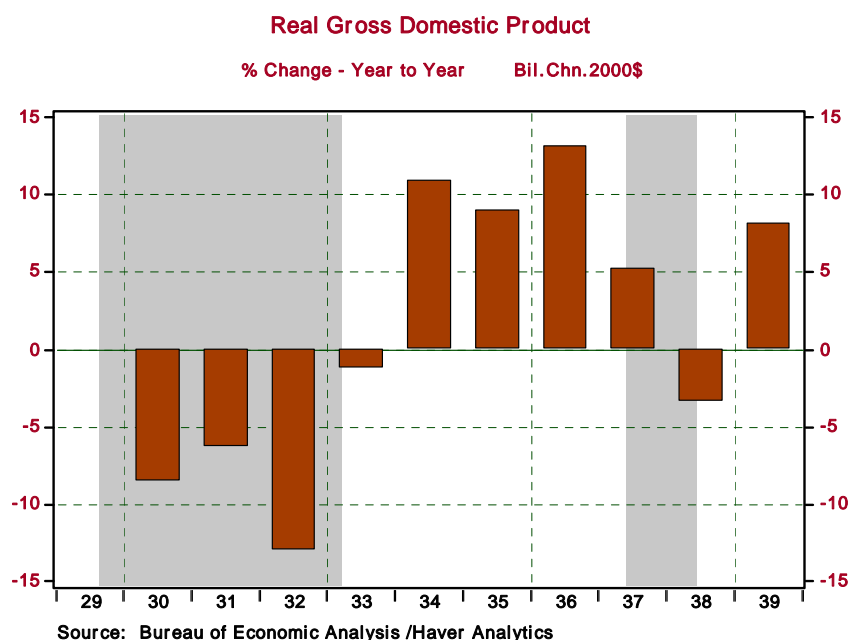


Source: Bureau of Economic Analysis /Haver Analytics



So, perhaps this current recession *will* be the worst since the Great Depression. Sounds ominous. But let's see how bad the Great Depression was in terms of real GDP contractions. The history is shown in Chart 2. Annual average real GDP contracted by 8.6%, 6.4% and 13.0% in 1930, 1931 and 1932, respectively. In 1938, real GDP contracted by 3.5%. Our point is that even if this recession is the most severe since the recessions of the 1930s, the severity of the current recession is unlikely to come anywhere near as severe as those during the Great Depression years. It is not our intention to minimize the severity of the current recession. But to say that the current recession is the worst since those of the Great Depression years could cause some to conjure up an economic calamity that just is *not* likely to occur.

Chart 2



As an aside, observe how strong real GDP growth was in 1934, 1935, 1936 and 1937 – 10.8%, 8.9%, 13.0% and 5.1%, respectively. Even though the economic recovery, which began in April 1933, a month *after* President Franklin D. Roosevelt was inaugurated for his first term, was quite strong, real GDP did not get back to its 1929 level until 1936 and the unemployment rate did not drop below 20% until 1936 (see Chart 3). Thus, the so-called output gap, the gap between *potential* real GDP and *actual* real GDP must have been very wide during these years. And if the output gap was wide, deflation must have persisted, right? Wrong! As shown in Chart 4, the annual average CPI *increased* by 3.5%, 2.6%, 1.0% and 3.7% in 1934, 1935, 1936 and 1937, respectively.

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Chart 3
 ← Civilian Unemployment Rate: 14 yr + SA, %

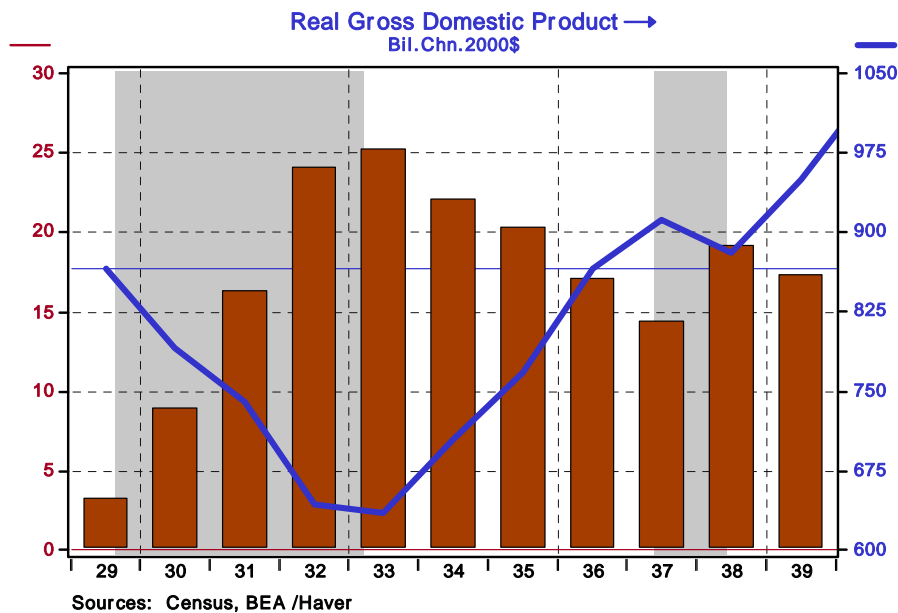
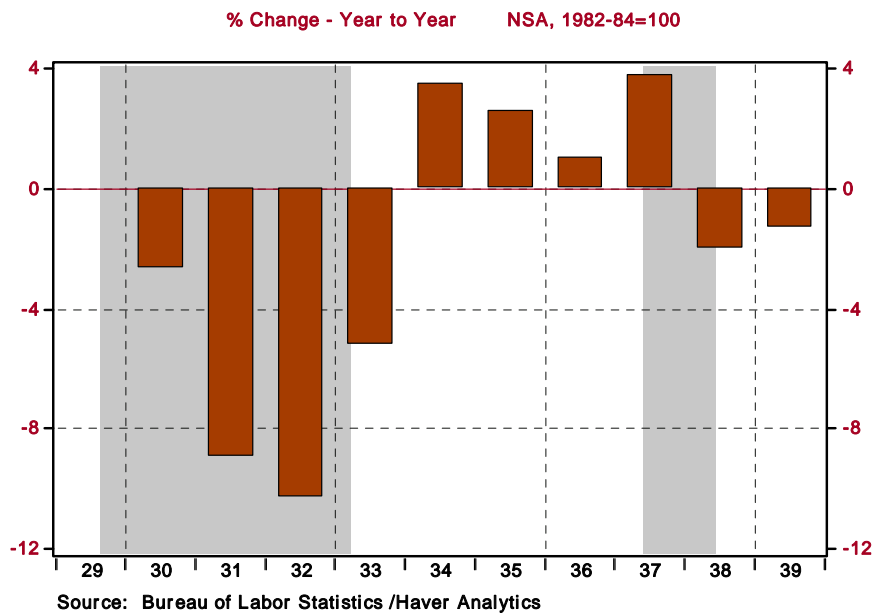


Chart 4
 CPI-U: All Items

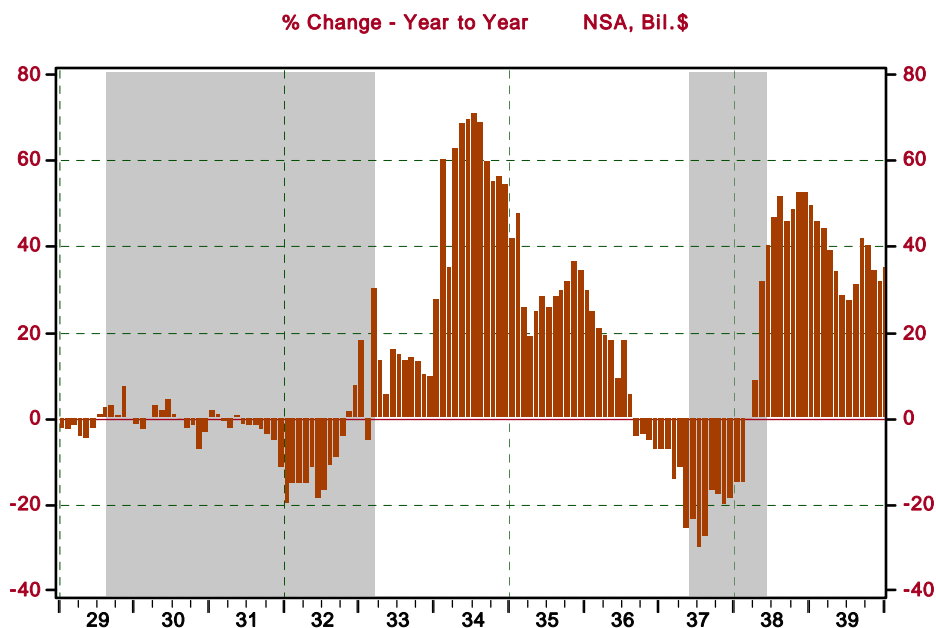


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To generate this kind of turnaround from deflation in 1933 to inflation in 1934, the Fed must have really had its money printing presses working overtime. Chart 5 shows that it did. The annual average of commercial bank reserves in 1934 was up 56.8% vs. 1933. The year-over-year increase in bank reserves in October 1934 was 70.7%.

Chart 5

Adj Reserves incl Deposits to Satisfy Clearing Balance Contracts



Source: Federal Reserve Bank of St Louis /Haver Analytics

All of which brings us to back to the current economic environment. In the two months ended November, commodity prices have fallen by 10.0%. Prior to this, the largest decline was 9.7% in the two months ended March 1921 (see Chart 6). During the 1930s, the largest decline in commodity prices was only 5.2% in the two months ended July 1930. So, are we likely to see persistent declining prices for commodities, goods and services in the next couple of years? Not if the Fed has anything to do with it. The rate at which the Fed has been increasing bank reserves is *ten times* that at which it was doing so in 1934. As Chart 7 shows, the year-over-year increase in bank reserves was 603.6% in November 2008. **The Fed's seasonally-adjusted net acquisition of assets – primarily securities, commercial paper and loans to financial institutions – represented 100% of the seasonally-adjusted total borrowing by the U.S. nonfinancial sector in the third quarter of 2008 (see Chart 8).** Talk about monetizing debt!

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Chart 6
PPI: All Commodities

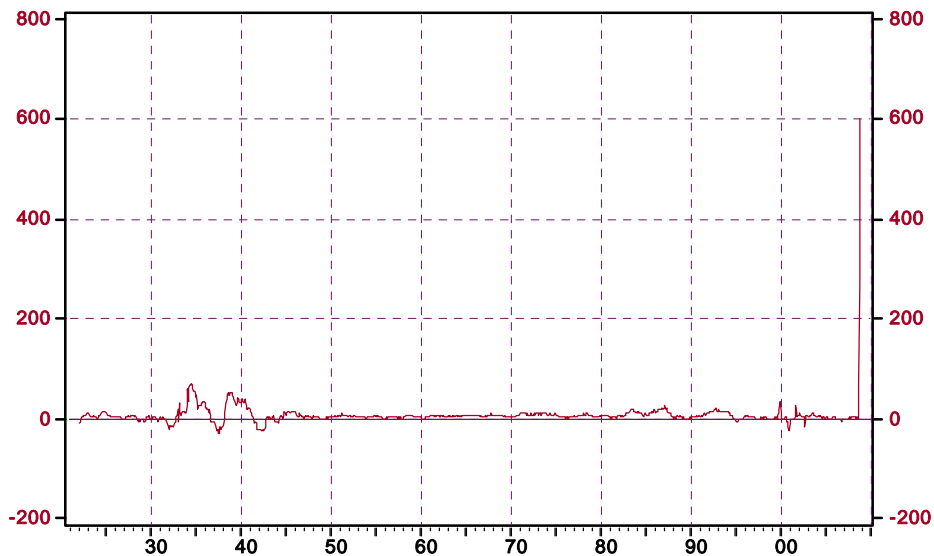
2-month %Change NSA, 1982=100



Source: Bureau of Labor Statistics /Haver Analytics

Chart 7
Adj Reserves incl Deposits to Satisfy Clearing Balance Contracts

% Change - Year to Year NSA, Bil.\$

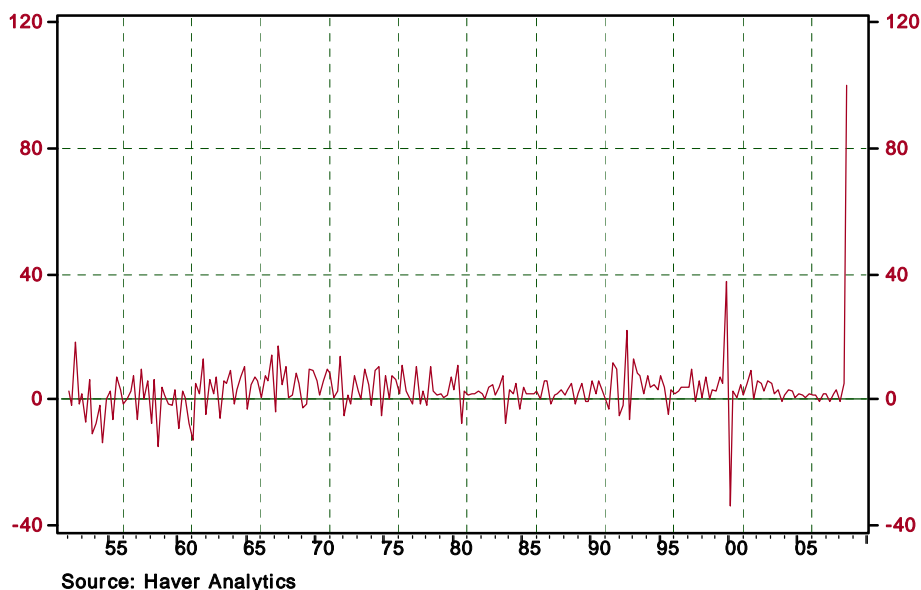


Source: Federal Reserve Bank of St Louis /Haver Analytics

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Chart 8

Fed's Net Acquisition of Assets as % of Domestic Nonfinancial Sector Borrowing

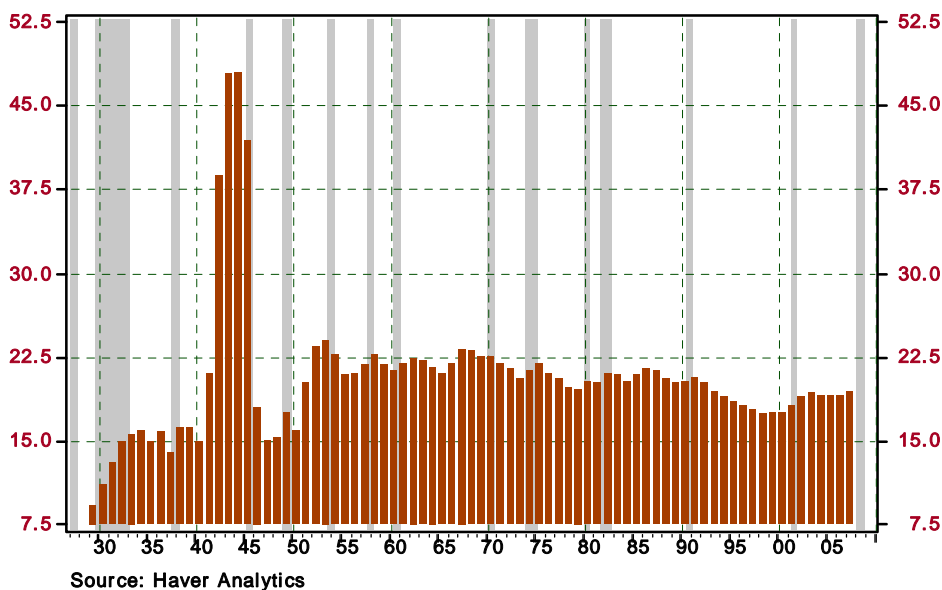


The incoming Obama administration is reported to be busy planning a two-year increased government spending program – spending on goods and services, above what will be spent on replacing “depreciated” financial capital – perhaps as much as \$1 trillion. As Chart 9 shows, total government spending on goods and services – federal, state and local – was 19.4% in 2007. The highest this ratio was during the 1930s was 16.1% in 1939. Let’s assume that nominal total government spending on goods and services in 2009 is \$500 billion over its average for the first three quarters of 2008 (\$2,871.9 billion). That would put nominal total government spending at \$3,371.9 billion for 2009. Let’s also assume that 2009 nominal GDP is the same as its average over the first three quarters of 2008, or \$14,288.6 billion. (We think there is a good chance that nominal GDP could *decrease* in 2009, which has not happened since 1949.) With these assumptions, the ratio of nominal total government expenditures to nominal GDP would rise 23.6% in 2009 – considerably higher than it was during Roosevelt’s New Deal era, slightly higher than Johnson’s Great Society era and the highest since 1953.

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Chart 9

Nominal Government Goods/Services Expenditures as % of Nominal GDP



Our hunch is that the Fed will be a major purchaser of the federal debt issued to fund this massive increased government spending program. Recall how quickly the CPI went from falling to rising in the 1930s. We think it is safe to say that the output gap in 2010 will be smaller in percentage terms than it was in 1934. It looks as though the Fed has its printing presses working ten times faster now than it did in 1934 and is likely to keep them running at high speed through 2009. Do you really think that deflation is a likely outcome over the next few years?

On political grounds, deflation is “not an option.” The U.S. is a net debtor economy to the tune of about \$7.1 trillion (see Chart 10). Households are up to their eyebrows in debt (see Chart 11). In a deflation, nominal income growth slows or contracts and the nominal value of assets may decline. But the nominal principal value of debt remains constant. Thus, in a deflation, the *real* value of debt increases. This is why debtors hate deflation. Although it is true that for every borrower there is a lender, a single lender probably has extended credit to more than one borrower. Thus, it is likely that there are numerically more voters who are net debtors than there are voters who are net lenders. If so, the political pressure on the Fed to inflate will be enormous.

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Chart 10
U.S. Foreign Financial Assets minus Foreign Financial Liabilities
 \$ Billions

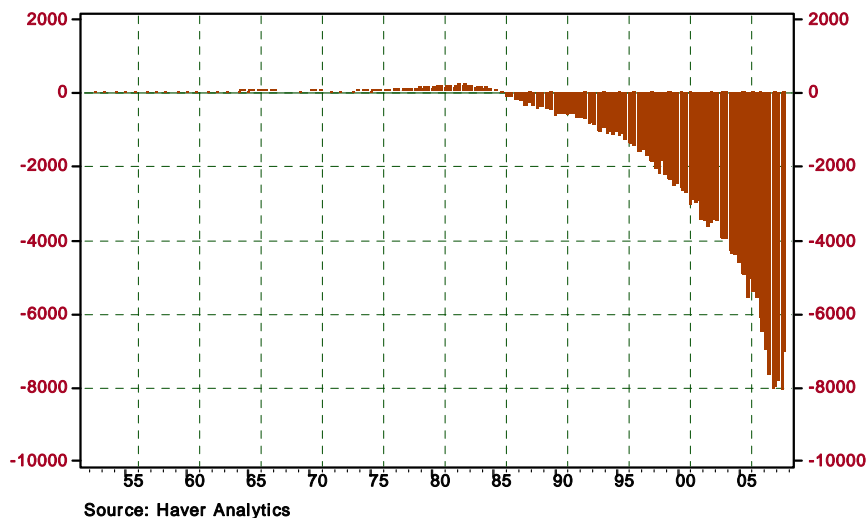
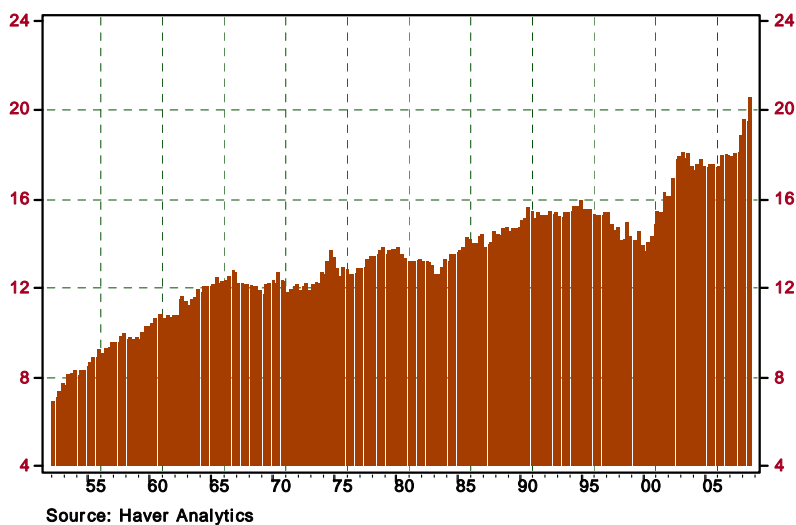


Chart 11
Households: Total Liabilities as % of Mkt. Value of Total Assets



If 1934 is any guide, the Fed, starting in 2010, may have to invest in industrial size vacuum cleaners to start sucking up large quantities of credit that it had previously created!

**Paul Kasriel is the recipient of the Lawrence R. Klein Award for Blue Chip Forecasting Accuracy*

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**THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
December 2008
SELECTED BUSINESS INDICATORS**

Table 1 US GDP, Inflation, and Unemployment Rate

	2007		2008				2009				Q4 to Q4 Change			Annual Change		
	07:3a	07:4a	08:1a	08:2a	08:3a	08:4f	09:1f	09:2f	09:3f	09:4f	2007a	2008f	2009f	2007a	2008f	2009f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	4.8	-0.2	0.9	2.8	-0.5	-5.0	-4.0	-2.0	-0.3	2.0	2.3	-0.5	-1.1	2.0	1.2	-2.1
CONSUMPTION EXPENDITURES	2.0	1.0	0.9	1.2	-3.7	-4.0	-2.3	-1.5	-0.5	2.0	2.2	-1.4	-0.6	2.8	0.3	-1.9
BUSINESS INVESTMENT	8.7	3.4	2.4	2.5	-1.5	-13.7	-11.3	-11.1	-7.5	-2.4	6.4	-2.8	-8.1	4.9	2.3	-8.7
RESIDENTIAL INVESTMENT	-20.6	-27.0	-25.1	-13.3	-17.6	-12.0	-10.0	-5.0	0.0	2.5	-19.0	-17.1	-3.2	-17.9	-20.4	-8.8
CHANGE IN INVENTORIES ('00 dlrs, bill)	16.0	-8.1	-10.2	-50.6	-29.1	-34.8	-53.4	-48.4	-38.4	-28.4				-2.5*	-31.2*	-42.2*
GOVERNMENT	3.8	0.8	1.9	3.9	5.4	0.4	0.4	1.1	2.7	2.4	2.4	2.9	1.6	2.1	2.8	1.8
NET EXPORTS ('00 dlrs, bill.)	-511.8	-484.5	-462.0	-381.3	-352.3	-358.6	-363.7	-362.4	-364.8	-367.0				-546.5*	-388.5*	-364.4*
FINAL SALES	4.0	0.8	0.9	4.4	-1.4	-4.7	-3.3	-2.2	-0.6	1.6	2.5	-0.3	-1.1	2.4	1.5	-2.0
NOMINAL GROSS DOMESTIC PRODUCT	6.4	2.3	3.5	4.1	3.6	-3.1	-3.8	-0.5	1.6	4.0	4.9	2.0	0.3	4.8	3.5	-0.5
GDP DEFLATOR - IMPLICIT (% change)	1.5	2.5	2.6	1.3	4.1	2.0	0.2	1.5	1.8	2.0	2.6	2.5	1.4	2.7	2.3	1.6
CPI (% Change, 1982-84 = 100)	2.8	5.0	4.3	5.0	6.7	-5.7	-0.1	1.7	2.0	2.2	4.0	2.5	1.5	2.9	4.0	0.7
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.7	4.8	4.9	5.3	6.0	6.7	7.3	7.8	8.1	8.3				4.6*	5.7*	7.9*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

SPECIFIC INTEREST RATES	Quarterly Average										Annual Average		
	07:3a	07:4a	08:1a	08:2a	08:3a	08:4f	09:1f	09:2f	09:3f	09:4f	2007a	2008f	2009f
Federal Funds	5.07	4.50	3.18	2.09	1.94	0.70	0.50	0.50	0.50	0.50	5.02	1.98	0.50
3-mo.LIBOR	5.45	5.03	3.26	2.75	2.91	2.75	1.65	1.40	1.05	0.75	5.30	2.92	1.21
2-yr. Treasury Note	4.38	3.48	2.02	2.42	2.36	1.25	0.90	0.90	1.00	1.25	4.36	2.01	1.01
10-yr. Treasury Note	4.73	4.26	3.66	3.89	3.86	3.35	2.65	2.65	2.75	3.00	4.63	3.69	2.76

a = actual
f = forecast

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